7/30/87 A3840-6

ECONOMIC OUTLOOK

Chamber of Commerce of the United States July/August 1987

STEADY AS SHE GOES

The current economic environment is one of some uncertainty. Over the last year or more, the U.S. economy has grown slowly, as have those of the leading nations of the world. In one direction, we see emerging evidence to suggest that economic growth could slip even further. At the same time, we still see many signs which demonstrate surprising strength. Pushed and pulled in different directions, economic forecasts now vary widely, and economists change their minds with alarming frequency.

Although the economy has been muddling along for more than a year, over the past two quarters, key sectors of the economy have turned down, including personal consumption expenditures which had been an important source of strength. On top of this are a number of other emerging trends that should concern us. Chief among them is the sharp decline and volatility in the value of the dollar, growing inflationary pressures, and rising interest rates.

It is in the international trade area where, paradoxically, we find both cause for concern and cause for optimism. First the good news. The decline in the dollar—nearly 50% against the yen and 34% against all currencies on a trade-weighted basis—will lead to a swift reduction in the trade deficit. On a quantity basis, imports peaked last November and have since fallen by nearly 3%. At the same time, exports have been rising since last year.

By the end of this year, exports will have increased by about 12% while import growth could decelerate to 2.7% from 10% last year. While this reversal is already underway, the general perception is one of no progress because of the preoccupation with the merchandise trade figures. For those deeply concerned about our trade deficit, this will be viewed as good news. But as we consider the many ways in which this deficit could be reduced, it is essential that we do not let it become the tail that wags the dog.

Trade deficits are subject to any number of cures, some of which are very harmful. Solutions that emphasize increased productivity and innovation are preferred because they make us more competitive and increase our standard of living by providing greater quality at lower cost. Currency depreciation will work in the short run, but must be supported by productivity-enhancing measures if the cure is to be permanent. Erecting barriers to trade is obviously the worst alternative. It solves the problem by simply reducing the number of competitors. Perhaps because of impatience, our government rejected a productivity-enhancing strategy and seems to have settled, at least for the moment, on currency depreciation as the only politically acceptable way to resolve the problem. Avoiding the third choice—protectionism and retaliation—is now the challenge that confronts Congress.

We are already beginning to experience some of the costs associated with the new exchange rate policy. Producer and consumer price indices have increased in recent months, partly as a result of the higher import prices. And as imports are reduced, economic growth abroad will slow which, in turn, could hurt our exports. In recent months, growth has slowed in Germany, Britain, and Canada, three of our major trading partners.

The impact on prices is not the only problem associated with a declining dollar. Trade in products and services is but a part of the commercial relations between nations. Just as important are the many financial and investment transactions that occur when investors abroad buy our financial or tangible assets, and vice versa. Any change in exchange rates will also induce changes in the capital account, which, in some circumstances, could create other problems for the domestic economy.

Dr. Richard W. Rahn, Vice President and Chief Economist.
Ms. Graciela Testa-Ortiz, Director, Forecast Section.

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TABLE I
UNITED STATES ECONOMIC OUTLOOK 1987–1989
Prepared by the U.S. Chamber of Commerce
(Percent change from previous period at seasonally adjusted annual rates.)

	QUARTERS									YEARS			
	Actual		Forecast							Actual	Forecast		
	86:4	87:1	87:2	87:3	87:4	88:1	88:2	88:3	88:4	1986	1987	1988	1989
GROSS NATIONAL PRODUCT													
Real GNP	1.1	4.8	1.4	2.9	4.0	4.0	3.4	3.5	3.3	2.5	2.6	3.5	2.5
Consumption	-0.4	-1.1	2.7	2.8	1.8	1.2	2.0	2.8	2.1	4.1	1.8	2.0	2.3
Residential Investment	5.2	-4.7	-1.5	-6.3	-1.2	-0.2	6.5	6.8	6.8	9.4	0.5	1.2	2.8
Nonresidential Investment	3.0	-9.7	4.6	4.5	2.8	6.9	5.6	5.6	3.5	-1.0	-0.7	5.1	2.8
Equipment	6.6	-9.2	8.0	7.5	4.5	7.0	5.4	5.6	3.8	4.2	2.7	6.0	2.8
Structures	-5.4	-10.5	-4.1	-3.1	-1.7	6.4	6.1	5.8	2.7	-11.6	-8.9	2.6	2.9
Exports	16.7	11.8	12.3	14.6	15.5	16.4	13.6	10.3	8.7	2.5	12.1	13.9	8.1
Real Net Exports (82$B)	-148.0	-133.7	-120.6	-110.6	-101.6	-91.7	-85.2	-81.1	-77.2	-147.8	-116.6	-83.8	-64.5
Imports	-0.5	-2.6	-1.0	3.2	4.9	5.4	6.1	5.6	4.6	10.4	2.7	4.7	3.4
Government Purchases	23.2	-24.2	8.2	4.1	12.2	-12.8	1.8	3.9	11.0	2.7	0.6	1.2	0.0
Final Sales	3.9	2.1	8.7	7.6	7.6	6.4	7.9	8.5	8.5	5.3	5.7	7.6	7.6
Change in Business Inventories (82$B)	-28.5	40.7	9.7	2.7	6.9	28.8	29.5	27.1	23.5	6.6	15.0	27.2	21.9
Industrial Production	3.3	3.2	4.1	3.4	6.2	5.9	4.8	4.7	4.6	0.5	3.1	5.1	2.8
New Car Sales (mill.)	11.5	9.4	9.7	10.0	10.1	10.6	11.1	11.5	11.6	11.6	9.8	11.2	10.9
Domestic Car Sales (mill.)	7.9	6.8	7.0	7.2	7.2	7.6	8.1	8.3	8.4	8.4	7.1	8.1	8.0
New Housing Starts (mill.)	1.70	1.79	1.64	1.64	1.62	1.66	1.74	1.76	1.82	1.82	1.67	1.75	1.72
EMPLOYMENT, WAGES & PRICES													
Civilian Unemployment Rate (%)	6.8	6.7	6.2	6.2	6.1	6.0	5.7	5.5	5.3	7.0	6.3	5.6	5.1
Compensation	2.7	0.0	2.7	3.2	3.6	4.6	4.8	5.0	5.2	3.0	2.1	4.2	5.3
Productivity	-1.5	0.4	0.0	0.8	1.7	1.3	0.8	1.0	0.9	0.7	0.1	1.1	0.7
Unit Labor Costs	4.4	-0.5	2.9	2.3	1.9	3.2	4.0	4.0	4.2	2.2	2.0	3.1	4.6
Consumer Price Index	2.9	5.3	5.1	5.0	4.7	5.7	5.1	5.3	5.3	1.9	4.0	5.2	5.1
Implicit GNP Deflator	0.7	4.2	3.9	3.9	3.8	4.3	4.4	4.6	4.6	2.6	3.2	4.2	4.8
Prime Interest Rate (%)	7.5	7.5	8.0	8.3	8.3	8.2	8.2	8.1	8.0	8.3	8.0	8.1	8.0
3-mos. Treasury Bill Rate (%)	5.4	5.5	5.7	5.7	5.6	5.6	5.5	5.4	5.4	6.0	5.6	5.5	5.5
Corporate Bond Rate (%)	8.7	8.4	9.2	9.0	8.7	8.6	8.5	8.5	8.5	9.0	8.8	8.5	8.7
Real Personal Disposable Income	-1.4	2.7	-4.8	5.1	1.7	1.8	1.7	3.7	2.0	2.9	0.2	2.0	2.3
Profits from Current Production ($B)[1]	196.1	206.6	202.9	210.0	219.5	222.1	226.0	228.5	227.9	197.1	209.7	227.4	216.2
GOVERNMENT FISCAL POLICY ($B)[2]													
Unified Receipts										769	841	912	972
Unified Outlays										990	1008	1080	1145
Unified Deficit										-221	-167	-168	-173

[1]After-tax corporate profits with inventory valuation and capital consumption adjustments.
[2]Unified budget figures on a fiscal year basis. FY86 data are actual.

SOURCE: U.S. Chamber of Commerce, Forecasting Section, using the Washington University model of the U.S. economy.

FORECAST ASSUMPTIONS

This month's forecast contains estimates of the National Income and Product Accounts for the first quarter of 1987. The forecast incorporates provisions of the recently enacted tax reform plan. The nation's money supply M(1) is assumed to grow by 8.2 percent during 1987, 7.9 percent in 1988 and 7.3 percent in 1989. The trade weighted exchange value of the dollar falls by 12.3 percent in 1987, 1.0 percent in 1988 and stabilizes in 1989. The federal minimum wage is not expected to increase.

As the dollar declines, many foreign investments in the U.S. have declined in value when expressed in home country currencies. Some Japanese and German investors have suffered up to a 50% reduction in the value of their U.S. holdings in terms of yen or marks, and the Taiwan Central Bank is reported to have lost $6 billion so far. If the dollar is expected to fall further, then foreign investors will hold dollar assets only if they receive a risk premium in the form of higher interest rates.

A few weeks ago it looked as if such fears would become self-fulfilling. If worried foreign investors withdrew or withheld funds, then the dollar's value would fall further and capital markets would be disrupted. Apparently, it was this fear that induced the Fed to step in and firm up the dollar with tighter monetary policy. In response, interest rates rose across the whole spectrum. Over the first half of this year, monetary growth has been very erratic, growing at annual rates of more than 40% in late 1986, and then turning negative in early 1987. Longer term corporate bonds are up almost a full percentage point, while residential mortgage rates have risen even more. With investment already weak and the economy fairly sluggish, the higher interest rates call into question expectations of sluggish growth in 1987. Yet fears that the outcome would be worse—and that there would be a recession—appear to have abated now that financial markets have stabilized and the dollar has firmed.

Although a stabilized foreign exchange market would allow the Fed to ease up, the possibility of renewed inflationary pressures provide another reason why it is likely to remain restrictive for the foreseeable future. Consumer prices, which rose by just 1.9% last year, jumped to 5.3% during the first quarter and averaged 5% during the past six months.

While the problems are numerous, they are also resolvable. There are positive steps we could take to restore higher growth. Behind the decline in consumer spending is an increase in savings and debt repayment. This will lead to a reliquification of the consumer sector and establish a strong base from which the next expansion can be launched. For much of the last several years, spending growth has outpaced income and a decline in the savings rate made up the difference. This can only go on for so long, and it looks as if the consumer called it quits last year. Recently, almost half the increase in personal income has been saved. This is a healthy sign; and while it will lead to some short-term sluggishness, in the end it will contribute to a strong rebound in 1988.

Making the transition all the more stable are the continuing gains in employment that have occurred in recent months. In June, the civilian unemployment rate fell to 6.1%, its lowest level since December 1979. The full implementation of tax reform in 1988 will also serve to give the economy a boost. The adverse impacts of the loss of preference items in the old code will have worked themselves out and set the stage for an upturn when the full rate reductions are made effective.

What we have then, is something akin to a transition year in which a mature expansion begins to adjust to new rules and realities. By 1988, we expect the consumer to be in much better shape financially. The worst of tax reform will be behind us and the lower rates and new opportunities will begin to manifest themselves. And finally, the trade situation will have stabilized and will no longer be a drag on the overall economy. As a consequence, 1988 economic growth should take off from the somewhat depressed state that will likely characterize this year.

Achieving this take off will require that our government avoid doing silly things that may disrupt the natural process of consolidation that is now underway. With growth near 2%, there is little margin for error. Although we cannot expect much in the way of positive steps—what with the composition of Congress and the proximity to the next elections—it is essential that Congress avoid doing something counterproductive, like raising taxes (which are already up to uncomfortably high levels as a share of income), re-regulating important segments of the economy, or enacting a protectionist trade bill.

We are at risk in these areas, as the current budget deliberations demonstrate. Congress proposes that we raise taxes by $19 billion this year, just as it enacts an urgent supplemental spending bill that provides funds to establish a National Weed Center and an ad campaign to urge Americans to eat more fish, among many other such proposals. If we can avoid many more of these outcomes, we can muddle through the year until the positive factors come into full force in 1988—giving us the longest recovery of the postwar era.

REAL EXPORTS AND IMPORTS
(PERCENT CHANGE, YEAR AGO)

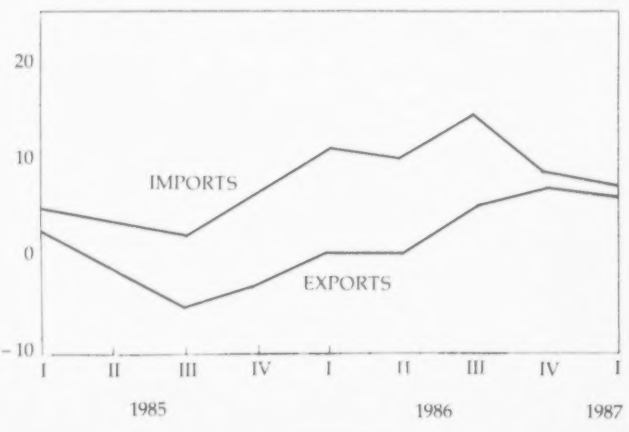

TABLE II
TRENDS IN COMMERCE

	Current Period		Previous Period	Year Ago	Percent Change From Previous Period	Percent Change From Year Ago
Population (millions) [a]	May/87	243.3	243.2	240.9	[c]	0.9
Gross National Product ($B)	I/87	4,352.1	4,258.7	4,149.2	2.1	4.9
Gross National Product (82$B)	I/87	3,739.4	3,696.1	3,655.9	1.2	2.3
Money Supply (M1) ($B)	May/87	739.2	737.2	640.5	0.3	15.4
Money Supply (M2) ($B)	May/87	2,825.6	2,821.5	2,598.9	0.1	8.7
PEOPLE AND THEIR MONEY						
Personal Consumption Expenditures ($B)	May/87	2,893.3	2,891.8	2,731.7	0.1	5.9
Personal Consumption Expenditures (82$B)	Apr/87	2,455.0	2,450.2	2,396.1	0.2	2.1
Disposable Personal Income ($B)	May/87	3,093.6	2,993.3	2,977.4	3.3	4.7
Disposable Personal Income (82$)	Apr/87	2,541.1	2,622.9	2,639.9	−3.1	1.9
Personal Savings Rate (%)	May/87	3.3	0.1	3.1	3.2[b]	0.2[b]
Civilian Employment (millions)	Jun/87	111.8	111.4	109.0	0.4	2.6
Civilian Unemployment Rate (%)	Jun/87	6.1	6.3	7.1	−0.3[b]	−0.8[b]
Average Hourly Earnings	Jun/87	$8.88	$8.90	$8.72	−0.2	1.8
Consumer Price Index (All Urban, 67 = 100) [a]	May/87	338.7	337.7	326.3	0.2	3.8
Prime Interest Rate (%) July 6, 1987		8.25	8.0	8.0	.25[b]	.25[b]
Retail Sales ($B)	May/87	124.0	124.8	119.6	−0.6	3.6
SERVICES SECTOR						
Employment in Services (millions)	Jun/87	77.0	76.9	74.7	0.1	3.0
Consumer Purchases of Service ($B)	May/87	1,532.9	1,526.7	1,426.1	0.4	7.5
Consumer Purchases of Service (82$B)	Apr/87	1,210.5	1,209.5	1,169.3	0.1	3.5
Domestic Revenue Passenger Mileage Flown						
Major Airlines (billions) [a]	May/87	27.4	27.7	24.5	−1.1	11.8
BUSINESS PROFITS AND OUTPUT						
Corporate Profits and Cash Flow ($B)						
Before Tax	I/87	267.6	259.6	222.5	3.0	20.3
Profits Tax Liability	I/87	128.8	115.1	95.7	11.9	34.5
Tax Liability as a Percent of Profits	I/87	48.1	44.3	43.0	3.8[b]	5.1[b]
After Tax	I/87	138.8	144.5	126.9	−3.9	9.3
Net Cash Flow	I/87	402.5	391.9	374.3	2.7	7.5
Industrial Production (77 = 100)	May/87	127.8	127.2	124.2	0.4	2.8
Capacity Utilization Rate (Mfg.) (%)	May/87	79.6	79.4	79.1	0.2[b]	0.6[b]
New Housing Starts (thou. units)	May/87	1,620.0	1,665.0	1,848.0	−2.7	−12.3
BUSINESS COSTS						
Unit Labor Costs (nonfarm) (77 = 100)	I/87	172.2	172.5	168.8	−0.1	2.0
Unit Nonlabor Costs (nonfarm) (77 = 100)	I/87	167.5	162.2	163.7	3.2	2.3
Producer Price Indices (67 = 100) [d]						
Crude Materials	May/87	304.7	295.5	279.4	3.1	9.1
Intermediate Goods	May/87	312.7	310.9	306.7	0.5	2.0
Finished Goods	May/87	296.3	295.0	288.9	0.4	2.6
FEDERAL SPENDING AND DEBT						
Federal Spending Index (67 = 100)	May/87	635.8	641.1	626.5	−0.8	1.5
Fed. Gov't Gross Debt Outstanding ($B) [a]	May/87	2,291.3	2,271.9	2,035.6	0.9	12.6
INTERNATIONAL TRADE						
Exports of Goods & Services ($B)	I/87	399.0	383.5	374.8	4.0	6.4
Imports of Goods & Services ($B)	I/87	506.9	493.7	468.5	2.6	8.1
Balance on Goods & Services ($B)	I/87	−107.9	−110.2	−93.7	−2.1	15.2
WHAT'S AHEAD?						
Index of Leading Indicators (67 = 100) [a]	May/87	189.3	187.9	178.5	0.7	6.0

NOTE: All data seasonally adjusted unless otherwise noted

[a] Not seasonally adjusted
[b] Percentage point difference
[c] Less than 0.05 percent
[d] Index number not seasonally adjusted, percent change seasonally adjusted

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E C O N O M I C
OUTLOOK

Chamber of Commerce of the United States September/October 1987

ECONOMIC EXPANSION MAKES HISTORY

The current economic expansion is unique by historic standards. As the economy enters its 59th month of recovery, all signs point to a continuation of healthy rates of economic growth--thus, virtually guaranteeing that the present recovery will become our longest peacetime expansion since 1796.

In addition to setting a longevity record, the current expansion has broken many others. Since November 1982, economic growth, on a yearly basis, has averaged 4.1%--the highest growth rate for any consecutive five-year period. But in contrast to other periods of rapid and sustained economic growth, inflation, rather than advancing, has actually been reduced--from an annual rate of 10.4% in 1981 to 1.9% in 1986. In addition, the reduction in marginal tax rates that brought the top rate from 70% in the 1970s to 28% in 1988, gives the U.S. the lowest income tax rate among industrial countries. This has created an economic environment conducive to investment growth and job creation.

Nearly fourteen million new jobs have been created since 1982, contributing to a record decline in the unemployment rate, which now stands at 6% compared to 9.5% in 1982. Other measures of improvements in the labor market are also evident: the civilian labor force participation rate rose to a record high of 65.3% in July, while the percentage of the adult population currently employed is at an all-time high of 61%.

As the number of job opportunities expanded, job quality also improved. There has been much speculation that a high proportion of the jobs created are low paying, low skill jobs. Yet, during the period 1981-85, 46.1% of the net new jobs created were in the high-wage category ($28,048 and over), while only 6% were in the low-wage category ($7,012) and under). In contrast, during the 1977-81 period, as much as 41.7% of the newly created jobs were in the low-wage category. As the share of high income jobs increased, so did median real family income. Over the last four years, median family income increased by 10.7%, the highest rise since the 1960s. Moreover, the increase in U.S. real per capita GDP has outstripped growth rates in the major industrial nations by a significant margin.

The data for July show that industrial production surged at a 9.7% rate, bringing the annual growth rate for the past three months to 7.8%. According to the National Association of Purchasing Management, the economy continued to grow vigorously in August. The buying agents' index rose to almost 60% in August, posting its 13th consecutive monthly increase and reaching its highest level since early 1984. And, after virtually no growth during the first nine months of 1986, manufacturing output has risen at a 4.8% annual rate. Output growth pushed the factory operating rate to 81% in August--the highest rate of capacity utilization in three years. More importantly, the index of leading indicators posted an impressive 0.5% increase in July, the sixth consecutive monthly increase.

Despite all the positive news, there are still those who doubt the economy's underlying strengths. At least one observer, Alfred Malabre of the *Wall Street Journal* contends that there is actually a recession under way. Looking at per capita disposable income, he points out that during the second quarter of this year, it fell by $149 from the first quarter, and is now at its lowest level since the first quarter of 1986. Is there really a recession under way? Is all the good news somehow masking a general decline in U.S. living standards?

Dr. Richard W. Rahn, Vice President and Chief Economist
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Ms. Rajni Bonnie Ohri, Economist

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GROSS NATIONAL PRODUCT													
Real GNP	1.5	4.4	2.3	3.4	3.3	3.6	3.9	4.0	3.3	2.9	2.7	3.5	3.3
Consumption	0.5	-0.7	2.1	3.7	1.2	2.8	2.5	3.1	2.1	4.2	2.0	2.5	2.6
Residential Investment	2.2	-7.7	-2.2	-6.5	-0.3	1.6	1.8	1.1	2.8	12.5	-0.4	0.0	2.9
Nonresidential Investment	5.1	-14.6	9.3	6.6	1.0	8.7	6.4	7.5	8.4	-2.3	-1.5	6.4	5.7
Equipment	4.7	-15.3	12.7	8.0	0.9	9.8	7.2	8.5	9.2	2.9	0.7	7.4	6.4
Structures	6.3	-12.8	1.0	2.9	1.4	5.7	4.4	4.8	6.3	-12.8	-7.0	3.9	3.9
Exports	9.5	10.2	12.1	14.5	14.9	14.1	9.2	8.3	6.6	3.3	10.5	12.0	7.2
Real Net Exports (82$B)	-151.8	-135.2	-133.3	-123.9	-114.2	-106.7	-102.9	-99.6	-97.0	-145.8	-126.6	-101.6	-86.9
Imports	-0.8	-5.2	7.4	3.5	3.9	5.3	4.6	4.3	3.5	10.5	3.9	4.6	3.3
Government Purchases	15.2	-18.6	7.3	17.7	12.4	-11.8	2.2	4.7	11.5	2.5	2.6	3.2	0.7
Final Sales	3.0	3.0	7.7	8.8	7.1	6.1	7.7	8.6	8.6	5.5	5.6	7.5	8.1
Change in Business Inventories (82$B)	-14.4	47.6	37.8	17.5	17.9	25.2	30.5	30.8	23.7	13.8	30.2	27.6	31.4
Industrial Production	3.3	3.2	3.7	9.1	4.4	4.8	5.8	5.5	4.4	0.5	3.6	5.4	4.0
New Car Sales (mill.)	11.3	9.5	10.0	10.9	9.7	10.4	10.9	11.2	11.3	11.4	10.1	10.9	11.3
Domestic Car Sales (mill.)	7.8	6.7	7.0	7.9	6.7	7.4	7.9	8.2	8.3	8.2	7.1	7.9	8.3
New Housing Starts (mill.)	1.70	1.79	1.62	1.62	1.63	1.63	1.63	1.67	1.69	1.82	1.66	1.66	1.70
EMPLOYMENT, WAGES AND PRICES													
Civilian Unemployment Rate (%)	6.8	6.7	6.2	5.9	5.8	5.8	5.6	5.5	5.4	7.0	6.1	5.6	5.3
Compensation	4.0	1.1	2.9	3.9	4.0	4.5	4.6	5.0	5.3	3.9	2.8	4.3	5.3
Productivity	0.0	0.4	1.5	0.9	1.3	1.3	1.4	1.4	1.0	1.7	0.5	1.3	1.1
Unit Labor Costs	4.4	0.5	1.1	3.2	2.7	3.1	3.2	3.5	4.2	2.1	2.3	3.1	4.2
Consumer Price Index	2.7	5.3	4.9	4.1	4.0	4.2	4.7	5.1	5.1	1.9	3.7	4.5	5.0
Implicit GNP Deflator	0.7	4.2	3.8	3.2	3.7	3.0	4.1	4.5	4.5	2.6	3.2	3.7	4.8
Prime Interest Rate (%)	7.5	7.5	8.0	8.5	8.6	8.7	8.8	8.8	8.8	8.3	8.2	8.8	8.9
3-mos. Treasury Bill Rate (%)	5.4	5.5	5.6	6.1	6.2	6.3	6.4	6.5	6.5	6.0	5.9	6.4	6.6
Corporate Bond Rate (%)	8.7	8.4	9.2	9.5	9.5	9.5	9.4	9.4	9.3	9.0	9.1	9.4	9.2
Real Personal Disposable Income	0.6	2.5	-3.8	4.9	1.5	2.5	1.9	3.5	1.8	4.1	1.0	2.2	2.4
Profits from Current Production ($B)[1]	167.2	165.9	163.8	163.3	169.3	180.1	179.8	184.2	183.6	179.4	165.6	182.0	183.1
GOVERNMENT FISCAL POLICY ($B)[2]													
Unified Receipts										769	853	910	964
Unified Outlays										990	1010	1080	1145
Unified Deficit										-221	-157	-170	-181

[1]After-tax corporate profits with inventory valuation and capital consumption adjustments.

[2]Unified budget figures on a fiscal year basis. FY86 data are actual.

SOURCE: U.S. Chamber of Commerce, Forecasting Section, using the Washington University model of the U.S. economy.

FORECAST ASSUMPTIONS

This month's forecast contains preliminary estimates of the National Income and Product Accounts for the second quarter of 1987. The forecast incorporates provisions of the recently enacted tax reform plan. The nation's money supply M(1) is assumed to grow by 6.3 percent during 1987, 7.6 percent in 1988, and 8.3 percent in 1989. The trade weighted exchange value of the dollar falls by 9.1 percent in 1987, 5.3 percent in 1988, and stabilizes in 1989. The federal minimum wage is not assumed to increase.

Hardly. An examination of the data shows that the real reason for the decline in inflation-adjusted, after-tax income lies in the "policy mistakes" that we have warned, could undermine the economy's impressive performance. The truth is that the drop in real income is not a product of declining output, but of tax reform. By delaying the full implementation of the tax rate cuts until next year while making the loss in deductions effective in 1986, tax reform effectively *raised*, not lowered, taxes. Indeed, the second quarter shows one of the greatest assaults on individual income by the tax system in recent history. In fact, almost 82% of last quarter's increase in personal income went to personal tax payments.

Thus, as we continue to enjoy this unprecedented period of prosperity, we should remain well aware of the risks inherent in bad economic policy. A major risk, as Mr. Malabre has inadvertently shown, is that of tax increases. It is worth repeating: our nation's budget deficit is not the result of tax cuts, but of unrestrained spending. In fact, the total tax burden (including state and local taxes and payroll taxes as well as federal taxes), of Americans is now at levels similar to those of 1978, the year which saw the beginnings of the "Great American Tax Revolt." In addition, increases in social security taxes are already scheduled to go into effect in January 1988.

A resurgence in inflation is another major threat to our economic well-being. The Fed's recent increase in the discount rate was a necessary step to forestall another inflationary run-up. Higher oil prices were the dominant force pushing up producer and consumer price indices through the first half of 1987. But since oil prices have edged down recently, we should expect a near term slowdown in the rate of price increases. For the relatively longer term, inflationary pressures will intensify for the following reasons: prices of imported goods will continue to strengthen reflecting the decline in the dollar's value; labor shortages have become more widespread in recent months (help-wanted ads reached a high for the year in July), as this continues it will place upward pressure on wages; and the upward drift in capacity utilization could bring it closer to the point where bottlenecks and shortages begin to occur. Moreover, the scheduled increases in the social security tax base and rate, which will reduce American's take-home pay, will also boost compensation and business costs, and hence, push up prices. Reflecting this, our forecast anticipates a 3.7% increase in the consumer price index this year, followed by increases of 4.5% and 5% in 1988 and 1989, respectively.

In addition to the specters of rising inflation and taxes, the economy faces other policy risks, including protectionism, re-regulation of important segments of the economy, and increases in the minimum wage.

Our forecast anticipates a 2.7% increase in real GNP this year, followed by a 3.5% increase in 1988. Real net exports continue to be an important source of strength, despite the recent deterioration in the merchandise trade deficit. The merchandise trade deficit, of course, measures only trade in goods in nominal dollars, and usually undergoes significant revisions. Inflation-adjusted net exports of goods and services, however, have improved steadily since mid-1986, narrowing the trade gap by about $30 billion in the last four quarters. We expect that improvement to continue. The only relatively weak sector in the near future is expected to be housing which is bearing the brunt of the run-up in interest rates. Nevertheless, housing starts are not anticipated to fall below 1.6 million units.

PER CAPITA REAL GDP AND ITS GROWTH RATES IN THE G-5 COUNTRIES AT PPP EXCHANGE RATES*

($ 1982)

	Levels			Growth Rates		
	1974	1980	1986	1974-80	1980-86	1974-86
Canada	$12,513	$13,643	$13,712	1.45%	0.08%	0.77%
Germany	10,220	11,846	11,266	2.49	-0.83	0.82
Japan	8,052	9,820	10,655	3.36	1.37	2.36
United Kingdom	9,224	9,769	9,956	0.96	0.32	0.64
United States	12,326	13,356	15,022	1.35	1.98	1.66

*Purchasing power parity (PPP) is the estimated exchange rate at which the currencies of two different countries would purchase the same bundle of goods and services in either country.

Source: OECD estimates of nominal per capita GDP at PPP deflated by U.S. GNP deflator, The Federal Reserve Bank of St. Louis, *International Economic Conditions*, August 1987.

TABLE II
TRENDS IN COMMERCE

	Current Period		Previous Period	Year Ago	Percent Change From Previous Period	Percent Change From Year Ago
Population (millions) [a]	Jul/87	243.8	243.7	241.6	[c]	0.9
Gross National Product ($B)	II/87	4,444.7	4,377.7	4,211.6	1.5	5.5
Gross National Product (82$B)	II/87	3,793.7	3,772.2	3,704.7	0.6	2.4
Money Supply (M1) ($B)	Jul/87	747.6	746.6	676.6	0.1	10.5
Money Supply (M2) ($B)	Jul/87	2,846.2	2,840.2	2,693.8	0.2	5.7
PEOPLE AND THEIR MONEY						
Personal Consumption Expenditures ($B)	Jul/87	2,993.1	2,967.5	2,812.4	0.9	6.4
Personal Consumption Expenditures (82$B)	Jun/87	2,496.8	2,482.1	2,464.0	0.6	1.3
Disposable Personal Income ($B)	Jul/87	3,176.7	3,164.8	3,029.3	0.4	4.9
Disposable Personal Income (82$)	Jun/87	2,662.8	2,676.8	2,654.1	−0.5	0.3
Personal Savings Rate (%)	Jul/87	2.8	3.3	4.1	−0.5[b]	−1.3[b]
Civilian Employment (millions)	Aug/87	113.1	112.7	110.1	0.4	2.7
Civilian Unemployment Rate (%)	Aug/87	6.0	6.0	6.8	−0.0[b]	−0.8
Average Hourly Earnings	Aug/87	$9.03	$8.96	$8.77	0.8	3.0
Consumer Price Index (All Urban, 67 = 100) [a]	Jul/87	340.8	340.1	328.0	0.2	3.9
Prime Interest Rate (%) Sept 8, 1987	Sep/87	8.75	8.0	7.50	0.75[b]	1.25[b]
Retail Sales ($B)	Aug/87	128.6	126.9	121.8	1.3	5.6
SERVICES SECTOR						
Employment in Services (millions)	Aug/87	77.4	77.3	75.1	0.1	3.1
Consumer Purchases of Service ($B)	Jul/87	1,583.1	1,568.6	1,466.4	0.9	8.0
Consumer Purchases of Service (82$B)	Jun/87	1,230.8	1,222.6	1,194.4	0.7	3.0
Domestic Revenue Passenger Mileage Flown						
Major Airlines (billions) [a]	Jul/87	29.6	27.6	27.6	7.2	7.2
BUSINESS PROFITS AND OUTPUT						
Corporate Profits and Cash Flow ($B)						
Before Tax	II/87	267.1	257.0	224.4	3.9	19.0
Profits Tax Liability	II/87	132.7	128.0	102.1	3.7	30.0
Tax Liability as a Percent of Profits	II/87	49.7	49.8	45.5	−0.1[b]	4.2[b]
After Tax	II/87	134.4	129.0	122.3	4.7	9.9
Net Cash Flow	II/87	384.6	378.7	363.3	1.1	5.9
Industrial Production (77 = 100)	Aug/87	130.7	129.8	125.1	0.3	4.5
Capacity Utilization Rate (Mfg.) (%)	Jul/87	80.5	80.1	79.3	0.4[b]	1.2[b]
New Housing Starts (thou. units)	Jul/87	1,611.0	1,597.0	1,786.0	0.9	−9.8
BUSINESS COSTS						
Unit Labor Costs (nonfarm) (77 = 100)	II/87	172.6	171.8	168.4	0.5	2.5
Unit Nonlabor Costs (nonfarm) (77 = 100)	II/87	169.3	167.4	165.2	1.1	2.5
Producer Price Indices (67 = 100)						
Crude Materials	Aug/87	307.7	307.8	276.3	0.4[d]	11.4
Intermediate Goods	Aug/87	318.2	317.1	304.5	0.4[d]	4.5
Finished Goods	Aug/87	297.2	297.8	288.1	0.0[d]	3.2
FEDERAL SPENDING AND DEBT						
Federal Spending Index (67 = 100)	Jul/87	637.0	640.0	622.3	−0.5	2.4
Fed. Gov't Gross Debt Outstanding ($B) [a]	Jun/87	2,313.1	2,291.3	2,036.6	1.0	12.1
INTERNATIONAL TRADE						
Exports of Goods & Services ($B)	II/87	411.0	397.3	371.3	4.0	6.4
Imports of Goods & Services ($B)	II/87	529.7	509.5	472.1	2.6	8.1
Balance on Goods & Services ($B)	II/87	118.6	112.2	100.8	−2.1	15.2
WHAT'S AHEAD?						
Index of Leading Indicators (67 = 100) [a]	Jul/87	191.8	190.8	179.9	0.5	6.6

NOTE: All data seasonally adjusted unless otherwise noted

[a] Not seasonally adjusted
[b] Percentage point difference
[c] Less than 0.05 percent
[d] Index number not seasonally adjusted, percent change seasonally adjusted